ISLAMIC BANKING

HISTORY OF ISLAMIC BANKING

- Beginning in the 1960s, many new interest-free banks opened. Though the majority of these institutions were founded in Muslim countries, Islamic banks also opened in Western Europe during the early 1980s.
- There are approximately 520 banks and 1,700 mutual funds around the world that comply with Islamic principles This growth is largely due to the rising economies of Muslim countries (especially those that have benefited from oil price increases).
- Ethiopia accommodated Islamic finance in its financial system through an interest-free banking window in 2011 and Full-fledged interest-free banking by the end of 2019. ZamZam Bank has established itself as the first **Islamic bank in** Ethiopia after obtaining a license from the banking regulator.

MEANING OF ISLAMIC BANKING

- Islamic banking is defined as a banking system that conforms to Islamic Shariah law and is in line with the religion's spiritual ethos and value system.
- Islamic banking is the conversion of traditional financial transactions into exchanges based on physical goods and practical services. Islamic Shariah serves as the foundation for Islamic banking's ideology. But the ideology doesn’t distract to achieve the banking system’s function.

WHAT IS MEANT BY “RIBA”?

- The Arabic word "Riba," which means "to increase" or "to exceed," is frequently used to refer to unfair trades or borrowing fees and penalties

Following the Qur'anic quotation

- ***" Those who eat Riba will not stand on the Day of Resurrection except like the standing of a person beaten by Shaitan. That is because they say: 'Trading is only like Riba', whereas Allah has permitted trading and forbidden Riba."***

TYPES OF RIBA

- **Riba-An-Nasiyah/Riba-Al-Quran**

Every loan that derives a benefit to the lender is Riba.

- **Riba-Al-Fadl**

A loan that derives a benefit to the lender but they can’t charge interest but they use something else.

Conventional Banking Vs Islamic Banking

1) Conventional Banking

- ✓ Follows widely accepted economic and financial theories that aim at maximizing profits.
- ✓ Time value is the basis for charging interest on capital.
- ✓ Purely economic and sometimes unethical/ illegal practices take place.
- ✓ There are no restrictions on interests. Banks receive interest on loans as well as investments.
- ✓ There are no restrictions on trading. As a result, investors speculate, and some even invest in high-risk assets to get high returns.
- ✓ While disbursing cash finance running finance or working capital finance no agreement for the exchange of goods & services is made.
- ✓ Conventional banks use money as a commodity which leads to inflation.

2) Islamic Banking

- ✓ Follows the Sharia law and is consistent with the teachings of the Quran
- ✓ Money is not a commodity though it is used as a medium of exchange and store of value. Therefore, it cannot be sold at a price higher than its face value or rented out.
- ✓ Cultural, ethical, and religious forms of banking
- ✓ Earns revenue through equity participation – profit sharing. When a client suffers a loss, the bank makes no profit. Hence, it aims to create real growth for society and its partners.
- ✓ Collecting interests from borrowers (Riba) is prohibited
- ✓ Investing or trading assets that involve speculation and high risk is against the law.

The Basic Principle Of Islamic Banking

1) *Profit and Loss Sharing:*

One of the core elements of Islamic banks is that partners should split profits and losses based on how much of a role they had in the company. On the rate of returns, there will be no assurance that Muslims will act as partners rather than creditors.

2) Shared Risk:

Islamic banking encourages risk-sharing in business transactions. According to the principles of Islamic banking, when two or more parties share the risk, the burden of the risk is decreased and split among the parties.

*3. Riba(*The prohibition of Usury*)*

The prohibition of interest Regardless of the outcome of economic activity, the person who gets the loan has to return the money no Riba to the lender.

4. Gharar:

Islamic financial principles forbid Muslims from taking part in confusing and uncertain transactions. Islamic law stipulates that both parties must exercise sufficient control over the business. Additionally, all information should be disclosed to all parties so that the profit and loss are split equally.

5) No Investment in Prohibited Industries:

Industries that are harmful to society or have a threat to social responsibilities are prohibited in Islam, including Pornography, Prostitution, Alcohol, Pork, and Drugs. One is not allowed to invest in such industries, or even participate in the mutual funds that will help the industry to flourish.

6) Zakat:

There is a property tax included in the rules of Islam that is known as Zakat, which allows the balanced distribution of wealth. According to Islamic banking principles, a fair amount of Zakat is deducted from the accounts of Muslims in the holy month of Ramadan. Islamic banks promote this social responsibility and distribute the amount among the needy.

THE WAY OF DEPOSITERS MAKE EARNING IN ISLAMIC BANKING

A depositor in an Islamic bank can therefore make earnings on his or her deposit in several ways:

- ✓ Through return on his capital.
- ✓ Through profit's sharing.
- ✓ Through rental earnings on an asset.

Operation of Islamic banking.

Islamic modes of financing are classified into

- **Fixed return** Such as Murabaha ijara, salamand istisnaa and
- **variable-return** mainly mudaraba and musharaka.

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1) Fixed-return modes,

Management to users of the capital or funds made available by investors.

For example, offer residual lights of control and

2) The variable-return mode of financing on the other hand offers the possibility of sharing residual financial rights.

Consequently, variable-return modes of financing have seen rather limited Application especially in Islamic retail banking.

Assets and Liabilities structures in Islamic banking

- Assets
- Cash and short-term funds Deposits and placements with banks and other financial institutions
- Short-term investment (i.e., Sukouk**)**
- Allowance for bad and doubtful financing.
- Financing and advances based on Islamic contracts Direct investment of Other assets and Fixed Assets Property, plant,and equipment.
- Other tangible assets and Intangible assets(i.e. ,goodwill)

Liabilities

- Deposits from customers
- Deposits and placements of banks
- other financial institutions’ Bills and acceptances payable.
- Provision for taxation and zakat
- Ordinary share capital
- Reserves
- Shareholder’s equity
- TOTALLIABILITIESAND
- SHARE HOLDER’SEQUITY
- Bank commitment and contingencies

Operation of Islamic banking

These are two

- Jordan Islamic Bank(JIB) and
- Kuwait Finance House(KFH).

Jordan Islamic bank(JIB)

The JIB was established in Amman in 1978 to conduct a full range of banking services within he limits permitted by Islamic Law " Shari'ah".

The bank was particularly concerned with :

- Providing such financial intermediation to all citizens of Jordan and adopting a policy of opening as many regional branches as possible.
- Provide traditional banking services to citizens of Jordan.
- The bank is offering financial, investment, and collective social activities operations on a non-usurious basis.

Kuwait Finance House(KFH).

It operates:

- First, conducting all banking operations and services on its own, or for the account of third parties, without practicing usury, whether in the form of interest or any other form.
- Second, carrying out direct investments, or purchase or finance projects or activities owned by others, on a non-usurious basis

Aims of Islamic banking

ECONOMICS aims

- To capture the saving of hundreds of millions of Muslim
- To establish subsidies for Islamic banking in Muslim and non-Muslim countries
- To satisfy the demand and financial operation management

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- **Social aims**

❖ **To promote and consolidate the operation of Islam**

❖ **To promote social development**

Risk or challenge in Islamic banking

- There several risks in Islamic banking on the side of asset and liability

Some of them are

- Credit risk
- mark up risk
- Operation risk
- market risk
- Liquidity risk

Risk management or controlling challenge method

- **There are different risk management methods in Islamic banking**
  1. Risk sharing
  2. Risk mitigation
  3. By using standard techniques

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THANK YOU!